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Craig W. Hammond
University of Michigan Law School

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LIMITING DIRECTORS' DUTY OF CARE LIABILITY: AN ANALYSIS OF DELAWARE'S CHARTER AMENDMENT APPROACH

Corporate directors are primarily responsible for monitoring the performance and decisionmaking of management.¹ To promote this role, two nonmarket² methods have been developed to ensure that directors take an active interest in reviewing management recommendations. The first method is to expose directors to potential duty of care liability. Although the legal definition of a director's duty of care is subject to different state interpretations, it essentially requires that directors make decisions in an informed manner and with reasonable care.³ The sec-

1. The monitoring model of the role of the board of directors recognizes that time and information constraints prevent directors from determining business policy on their own. The role of the board is therefore limited to a supervisory function; the board holds management accountable for adequate results, while management retains responsibility for determining what business policies to pursue. Effective monitoring requires that directors remain independent of the chief executive and sufficiently informed of the bases of management decisions. See M. EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 164-66 (1976).

Recent cases have been particularly concerned with the failure of directors to perform their monitoring role adequately. See *infra* note 22 (discussing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), and *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986)).

2. For a discussion of market mechanisms that encourage director diligence in supervising management, see *infra* notes 28-31 and accompanying text.

3. Duty of care liability was originally based on the common law requirement that directors make such reasonable inquiry as circumstances required. In *Barnes v. Andrews*, 298 F. 614, 615 (S.D.N.Y. 1924), Judge Learned Hand described the monitoring role of a corporate director and his common law fiduciary duty of care as follows:

[A director's] liability must therefore depend on his failure in general to keep advised of the conduct of the corporate affairs. The measure of a director's duties in this regard is uncertain; the courts contenting themselves with vague declarations, such as that a director must give reasonable attention to the corporate business. While directors are collectively the managers of the company, they are not expected to interfere individually in the actual conduct of its affairs. To do so would disturb the authority of the officers and destroy their individual responsibility, without which no proper discipline is possible. To them must be left the initiative and the immediate direction of the business; the directors can act individually only by counsel and advice to them. Yet they have an individual

ond, and more recently developed,⁴ method is to encourage the seating of outside independent persons on corporate boards. Outside directors are believed to be more likely to question and challenge management decisions than inside directors who are themselves corporate officers.⁵

Directors' reluctance to expose themselves to the enormous potential costs and liability that can arise from duty of care litigation⁶ forces corporations to provide some sort of protection against this vulnerability. Until recently, most corporations indemnified their directors against duty of care derivative suits by purchasing directors and officers liability insurance (D & O insurance).⁷ As a result of recent increases in the volume of share-

duty to keep themselves informed in some detail, and it is this duty which the defendant in my judgment failed adequately to perform.

Recently, the American Law Institute's Corporate Governance Project has attempted to codify a model definition of the duty of care. Section 4.01 provides:

A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position under similar circumstances.

AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01(a), at 6 (Tent. Draft No. 4, 1985) [hereinafter Tentative Draft No. 4].

States differ in their interpretation of duty of care standards. See Tentative Draft No. 4, 29-43 (reporter's note to § 4.01(a)) for a survey of duty of care standards under state laws. In Delaware, a director's duty of care liability must be "predicated upon concepts of gross negligence." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); see also *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985).

4. See *The Job Nobody Wants*, BUS. WK., Sept. 8, 1986, at 56, 56 [hereinafter BUSINESS WEEK] ("It was not until the 1960s that, under pressure from Washington and Wall Street, companies began to emphasize the election of outsiders.").

5. A great deal has been written on the role of the outside director. Two seminal works are M. EISENBERG, *supra* note 1 and M. MACE, *DIRECTORS: MYTH AND REALITY* (1971). See M. EISENBERG, *supra* note 1, at 172 ("Since the board's principal function is to monitor management's performance, and since a director who is not independent can scarcely be trusted to perform that function, board membership for such persons seems counterproductive.").

6. Damages for duty of care violations are based on the tort principle that a negligent party should be liable for all the foreseeable consequences resulting from his negligence. This can lead to potentially staggering liability in the context of a large modern corporation. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). After the Delaware Supreme Court found the directors liable for breaching their duty of care, the parties agreed to settle for \$23.5 million. The indemnification insurance policy covered only \$10 million of the settlement, but, fortunately for the directors, the acquiring Pritzker group paid the difference.

7. D & O insurance first appeared in the 1960's and has been a subject of controversy ever since. For a discussion of the coverage of D & O policies and the debate over the merits of indemnifying directors against duty of care liability, see J. BISHOP, *THE LAW OF CORPORATE OFFICERS AND DIRECTORS: INDEMNIFICATION AND INSURANCE* (1981):

The fundamental policy considerations are, of course, on the one hand, fairness to the individual and the need to induce competent people to serve, or at least not to discourage them from serving, as corporate directors and officers, balanced against, on the other hand, the undesirability of immunizing corporate

holder derivative actions,⁸ and the size of court awards,⁹ however, D & O insurance premiums have skyrocketed.¹⁰ Many companies can no longer find, or afford, insurance for their directors.¹¹ Without D & O insurance, corporations are finding it difficult to attract and retain qualified outside directors.¹² A number of corporations have suffered mass resignations of outside directors when it was discovered that they could not renew their liability insurance.¹³

The inability of corporations to indemnify their directors has led to an alarming trend. For the first time since the 1960's, the

management, or permitting it to immunize itself, from the consequences of its negligence or misconduct.

Id. ¶ 1.02.

8. A 1986 study by the Wyatt Company compared the amount of litigation against directors in 1974 with that in 1984. The survey found that the number of companies reporting one or more claims against directors and officers rose 162%, an increase from 7.1% to 18.6%. Lewin, *Director Insurance Drying Up*, N.Y. Times, Mar. 7, 1986, at D1, cols. 2, 3.

9. *Id.* The Wyatt Study also found that the percentage of claims with payment over \$1 million increased 73%, from 4.8% to 8.3%, and the average defense cost per claim increased 154%, from \$181,500 to \$461,000.

10. A 1986 study by Korn/Ferry International, a management search firm, found that D & O insurance premiums on the average rose 362% from 1984 to 1985. At the same time, total dollar coverage decreased on the average from \$59,064,000 to \$34,131,000. KORN/FERRY INT'L, THIRTEENTH ANNUAL BOARD OF DIRECTORS STUDY 20 (1986) [hereinafter BOARD OF DIRECTORS STUDY]. See *infra* note 12 for other findings of the study.

11. The *New York Times* noted:

Most companies are experiencing a double blow: The amount of coverage they can get has been cut drastically, from as much as \$50 million to \$150 million last year to \$10 million to \$35 million, while the premiums they must pay for even that reduced coverage have increased as much as tenfold. And in certain industries—such as steel, petroleum and electronics—there may be a problem simply finding an insurer.

Lewin, *supra* note 8, at D1, col. 3.

12. A 1985 study by Korn/Ferry International surveyed 592 corporations from a broad range of American businesses. They found:

1. Sixty percent of the companies polled said that recent court decisions affecting overall responsibilities of corporate boards are creating potentially dangerous precedents, inhibiting a company's ability to attract new directors. Thirty-four percent said they thought recent court decisions would hurt them in retaining existing directors.

2. Nearly 62% of the chief executive officers polled said they will reduce the number of directorships they accept because of increased liability.

3. Fifty-two percent of the companies polled reported that the sharp rise in directors' and officers' liability insurance will make it more difficult to recruit high level outside directors. The companies surveyed said they are paying, on average, 362% more for D & O coverage this year than last year, and some companies cannot get D & O insurance at any price.

4. One out of five qualified candidates turned down an invitation to serve as a director.

BOARD OF DIRECTORS STUDY, *supra* note 10, at 1.

13. BUSINESS WEEK, *supra* note 4, at 56 (citing 10 instances since 1984 where the loss of liability insurance has led to mass resignations of outside directors).

makeup of boards is shifting to company insiders.¹⁴ The percentage of outside directors on the boards of the largest 1000 industrial companies dropped to 57.5% in 1986 from 63.2% in 1985.¹⁵ The trend is likely to continue if insurance costs do not decrease.¹⁶ This shift is particularly troublesome because it comes at a time when courts are requiring directors to take a more active role in scrutinizing the behavior of management in the face of hostile takeovers, leveraged buyouts, and other vital corporate concerns which often pit management's interests against the interests of the shareholders.¹⁷

A less obvious, but equally harmful, by-product of the insurance crunch is its chilling effect on entrepreneurial activity. Excessive duty of care liability can deter the willingness of directors to engage in risk-taking activity.¹⁸ Excessive potential liability also can affect the quality of a director's decision. Al-

14. *Id.* at 57. If corporate boards are dominated by insiders, then their ability to monitor management's actions will be greatly impaired. *See also supra* note 5 and accompanying text.

15. *Id.* at 57. Heidrick & Struggles, an executive search firm, provided statistics based on their annual survey of major corporations. This is the first marked decline since 1966, when the firm initially began tracking these numbers.

16. *Id.* at 56 (quoting a director of an executive search firm who predicted "[a] trend toward smaller boards, fewer meetings, and more inside directors"). This could effectively lead to a return to the traditional style of directing where the board acted as a rubber stamp for management.

17. Several recent cases have emphasized the importance of impartial behavior by outside directors when faced with a hostile bid. *See, e.g.,* *Edelman v. Fruehauf Corp.*, 798 F.2d 882 (6th Cir. 1986):

Once it becomes apparent that a takeover target will be acquired by new owners, whether by an alleged "raider" or by a team consisting of management and a "white knight," it becomes the duty of the target's directors to see that the shareholders obtain the best price possible for their stock. "The directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."

Id. at 886-87 (quoting *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986)).

18. Professor Conard first advanced this argument:

Another probable avoidance response to the threat of liability claims is to expend great effort on establishing a record of diligence. Directors may refuse to make decisions unless they are supplied with opinions of accountants certifying the accuracy of financial statements, appraisers' estimates of the value of properties, forecasts by management consultants of profit prospects, engineers' analyses of production costs, and lawyers' opinions about the legality of a course of conduct. Directors may insist, as a condition of affirmative action, that the documents take strong positive views of a proposed course, so as to prove on any later audit that the directors used "due diligence." Such an attitude would force managers to find and use consultants who tend more toward optimism than toward candor and illumination. In this way, the fear of liability may tend to degrade, rather than to elevate, the decisional processes of directors.

Conard, *A Behavioral Analysis of Directors' Liability For Negligence*, 1972 DUKE L.J. 895, 903-04 (citations omitted).

though some directors may reach more sound decisions than they otherwise might if not threatened with liability, others may be so concerned with maintaining a documented record of diligence in order to ensure protection under the business judgment rule that, consequently, their attention is diverted away from solving the company's problems.¹⁹

These concerns over excessive director liability were heightened in early 1985 when the Delaware Supreme Court decided *Smith v. Van Gorkom* (the *Trans Union* case).²⁰ Before *Trans Union*, courts rarely found individual directors liable for breaching their duty of care in the absence of some form of self-dealing.²¹ In *Trans Union* the court reversed this trend by holding a board of directors liable for breaching its duty of care despite the lack of any evidence indicating bad faith or self-dealing. The directors' liability was predicated on their failure to inform themselves and deliberate sufficiently before approving a take-over offer.²²

Recent business articles support this concern. See, e.g., Lewin, *supra* note 8, at D1, col. 4 (citing New York lawyer Martin Lipton's observation of "a real risk of overcaution" caused by excessive liability exposure). But see Frankel, *Corporate Directors' Duty of Care: The American Law Institute's Project on Corporate Governance*, 52 GEO. WASH. L. REV. 705, 713 (1984) ("The duty of care, however, helps ensure that directors are attentive to prevent the kind of risk that does not benefit the corporation.").

19. See Conard, *supra* note 18, at 904-05.

20. 488 A.2d 858 (Del. 1985).

21. Commentators often cite Professor Bishop's seminal article on the indemnification of corporate directors, in which he noted that "[t]he search for cases in which directors of industrial corporations have been held liable in derivative suits for negligence uncomplicated by self-dealing is a search for a very small number of needles in a very large haystack." Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1099 (1968); see also Cohn, *Demise of the Director's Duty of Care: Judicial Avoidance of Standards and Sanctions Through the Business Judgment Rule*, 62 TEX. L. REV. 591, 591 (1983) ("Cases that assess damages against negligent management are rare to the point of becoming an endangered species.").

Most commentators agree that mismatched liability for duty of care violations has led to judicial nullification of the duty of care principle in many circumstances. See Conard, *Theses For a Corporate Reformation*, 19 U.C. DAVIS L. REV. 259, 267 (1986):

Trial judges, whom higher courts recurrently find to have made erroneous rulings, are understandably reluctant to impose million-dollar liabilities on their counterparts in commerce whose decisions appear to have been in error. Courts find many ways, the foremost of which is the business judgment rule, to negate the application of the liability principle.

However, since the New Jersey Supreme Court decided *Francis v. United Jersey Bank* in 1981, courts have been willing to impose director liability for duty of care violations in cases involving financial institutions. See *Fitzpatrick v. Federal Deposit Ins. Corp.*, 765 F.2d 569 (6th Cir. 1985); *Joy v. North*, 692 F.2d 880 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983); *Francis v. United Jersey Bank*, 87 N.J. 15, 432 A.2d 814 (1981).

22. *Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985). Briefly stated, a class suit was filed against Van Gorkom, who was the Chief Executive Officer, and the *Trans*

In response to the *Trans Union* decision and the problems created by the insurance crisis, the Delaware legislature modified its duty of care provisions. Effective July 1, 1986, section 102(b) of the Delaware General Corporation Law, which enumerates the provisions a Delaware corporation may include in its certificate of incorporation, was amended by the addition of subsection (7).²³ The new section 102(b)(7) is an enabling act that permits corporations, through stockholder-approved charter amendments, to eliminate or limit their directors' monetary liability for violations of their duty of care.²⁴ The possible elimina-

Union board alleging a breach of duty by the directors in approving a merger offer from the Pritzker group. The Delaware Supreme Court found that the directors were not entitled to the protection of the business judgment rule because their decision was not an informed one. The directors failed to conduct a valuation study or make other efforts to determine whether the price offered was fair. Subsequent attempts to solicit other competing offers were found to be ineffectual because of the constraints imposed by the Pritzker pre-merger agreement. The shareholders' ratification of the proposal did not excuse the directors because the shareholders had been misled into believing that the directors had carefully negotiated a fair price.

For an analysis supporting the Delaware Supreme Court's application of the duty of care in the *Trans Union* decision, see Burgman & Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the Trans Union Case*, 11 J. CORP. L. 311 (1986). For a criticism of the decision, see Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985).

Subsequent cases in other jurisdictions have also found directors liable for duty of care violations when they failed to deliberate sufficiently before approving a takeover offer. See *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264 (2d Cir. 1986):

It is not enough that directors merely be disinterested and thus not disposed to self-dealing or other indicia of a breach of the duty of loyalty. Directors are also held to a standard of due care. They must meet this standard with "conscientious fairness." For example, where their "methodologies and procedures" are "so restricted in scope, so shallow in execution, or otherwise so *pro forma* or halfhearted as to constitute a pretext or sham," then inquiry into their acts is not shielded by the business judgment rule.

Id. at 274 (citations omitted).

See also *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886 (6th Cir. 1986) (citing the above excerpt from *Hanson* in support of a similar decision to forbid business judgment rule protection of a rubber stamp decision of outside directors).

23. DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1986) reads as follows:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under section 174 of this Title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to a member of the governing body of a corporation which is not authorized to issue capital stock.

24. See *supra* note 3 for a discussion of the duty of care standard in Delaware.

tion of monetary damages does not excuse directors of their duty of care. Directors will still be charged with the duty of care in their decisionmaking process, and courts will be able to provide equitable remedies in relevant cases such as mergers or acquisitions in which the plaintiffs are suing for injunctive relief. This enabling act does not permit exemptions from liability in cases of bad faith, breach of loyalty, or any other form of self-dealing.²⁵

Because of Delaware's preeminence in the field of corporate law, many states are likely to follow with similar legislation that will permit corporations to limit duty of care liability.²⁶ This Note explores the corporate law principles guiding the amendment of section 102(b)(7) and considers what effects this statute will have on the investor-director relationship. The Note focuses on whether this reform measure excessively protects directors at the expense of shareholders.

Part I analyzes the neoclassical economic view of the contractual relationship between stockholders and management that serves as the theoretical justification of section 102(b)(7). Part II proposes a modification of the Delaware statute that would pro-

25. Exemption from personal liability can only apply to the actions of directors *qua* directors. The statute does not shield from monetary liability inside directors who make decisions in their capacities as officers.

26. Before the enactment of the new Delaware legislation, both Indiana and Virginia had already adopted novel approaches to the insurance crisis. The Indiana legislature completely emasculated directors' duty of care liability. Effective April 1, 1986, Indiana amended § 23-1-35-1 of the Indiana Code to eliminate any duty of care liability unless the breach or failure to perform constituted willful misconduct or recklessness. IND. CODE ANN. § 23-1-35-1(e) (West Supp. 1986). Virginia redefined directors' duty of care narrowly in terms of a subjective good faith business judgment, thereby eliminating an objective standard. VA. CODE ANN. § 13.1-690 (1985).

Michigan has recently enacted legislation similar to Delaware's. Effective March 1, 1987, § 450.1209 of the Michigan Compiled Laws allows corporations to include in their articles of incorporation a provision eliminating or limiting directors' monetary liability for duty of care violations. Act No. 1, § 209, Enrolled Senate Bill No. 18 (Feb. 27, 1987) (to be codified at MICH. COMP. LAWS § 450.1209).

Other states will no doubt feel compelled to reduce directors' liability in order to compete successfully with Delaware for corporate charters. Corporate law scholars have debated the wisdom of this state competition. Advocates of federal regulation of corporations argue that state competition produces a regulatory system that caters to management interests at the expense of shareholder welfare. See, e.g., Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). The neoclassical school disagrees with this theory, arguing that state competition leads to the development of optimal laws. See Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982). For a recent empirical study of why firms choose to incorporate or reincorporate in Delaware, see Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985).

vide for periodic shareholder review of charter amendments limiting liability.

I. CHARTER AMENDMENTS AND AGENCY COSTS THEORY

The Delaware legislature's addition of section 102(b)(7) is not merely an attempt to reverse an unpopular court decision. The amendment appears to represent a shift in the traditional theoretical underpinnings of the investor-management relationship. Instead of relying on duty of care liability rules to monitor management actions, this new approach relies on market constraints and private contracting to protect shareholder interests. This Part analyzes the desirability of leaving shareholders and directors responsible for contractually determining liability through charter amendments.

A. *Investor-Management Relations: The Neoclassical Theory of the Firm*

Over the past decade, the escalation of derivative suits and indemnification costs has divided scholars over the utility of liability rules that enforce the duty of care.²⁷ All recognize that without any constraints directors may tend to "fall asleep at the wheel" and simply serve as rubber stamps for management deci-

27. Numerous articles have presented both sides of the issue. For an example of the neoclassical economics argument criticizing the use of liability rules, see Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261 (1986). Fischel and Bradley cite empirical evidence in support of their claim that liability rules do not play a fundamental role in aligning the interests of investors and managers.

In defense of the duty of care, see Frankel, *supra* note 18. Frankel responds to critics of the duty of care who claim that it is too costly and ineffective.

The American Law Institute's (ALI) attempt to draft its *Principles of Corporate Governance* has sharpened the scholarly debate over the utility of duty of care liability. The current draft supports the imposition of duty of care liability under a monitoring model. See Tentative Draft No. 4, *supra* note 3, § 4.01. With respect to the controversy over limiting duty of care liability, the ALI is currently considering its own innovative proposal that would allow corporations to limit duty of care liability to the amount of benefits that a director or an officer receives. The ALI has not yet officially agreed to a position on this issue. See AMERICAN LAW INST., *PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS*, § 7.17 (Tent. Draft. No. 6, 1986) [hereinafter Tentative Draft No. 6]. For a discussion of the ALI position, see Coffee, *Litigation and Corporate Governance: An Essay on Steering Between Scylla and Charybdis*, 52 GEO. WASH. L. REV. 789 (1985). See also *infra* notes 28-34 and accompanying text for a detailed discussion of the debate.

sions. Disagreement arises over the necessity for liability rules to constrain management negligence.

Two schools of thought have developed. Proponents of the neoclassical market model argue that duty of care liability is costly and unnecessary because market mechanisms adequately constrain directors' behavior.²⁸ These market constraints arise from the efficient workings of three markets: the securities market, the executive employment market, and the products market.²⁹ Greatly simplified, the argument turns on the premise that a poorly run firm will be subject to hostile takeovers and other market responses that threaten the job security and prestige of management and otherwise reduce the value of management's services.³⁰ The stock price will reflect any harm to the corporation caused by management's negligence. If the likely decrease in personal wealth and prestige of management resulting from the lower price is not alone an effective deterrent against negligence, directors must also recognize that the stock market functions as a market for corporate control. If the price drops too low, directors may lose their jobs in a hostile takeover.³¹

Critics of the neoclassical model argue that market constraints are not consistent enough to deter and discipline inefficient management.³² These critics defend the imposition of duty of care liability as a necessary mechanism for protecting share-

28. See, e.g., Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982); Fischel & Bradley, *supra* note 27; Phillips, *Principles of Corporate Governance: A Critique of Part IV*, 52 GEO. WASH. L. REV. 653 (1984); Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 936 (1983). Professor Scott argues that duty of care liability is of minor importance because the capacity of the board members to prevent bad decisions is inherently limited by their ex post facto monitoring role. The director's job is "to distinguish bad decisions from bad luck in the aftermath of a bad outcome." *Id.*

29. See Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 836-42 (1981).

30. For a more thorough discussion of the functioning of the market for corporate control, see *id.* at 841-45.

31. Phillips lists four principal reasons why management would want to avoid a decrease in the value of the corporation's securities: (1) increased likelihood of hostile takeovers, (2) decline in wealth of the manager's personal stock holdings in the corporation, (3) decreased likelihood of alternative bids for the manager's services, and (4) a decrease in market value that would increase capital costs and thereby decrease the corporation's ability to compete in the corporation's product markets. Phillips, *supra* note 28, at 674-75.

32. For example, when corporations adopt antitakeover measures such as poison pills and dual class capitalization plans, they impede the market for corporate control by substantially raising the transaction costs of acquiring the corporation. See Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145 (1984). Coffee argues that the enormous costs involved in mounting hostile bids means that this deterrent force "is likely to be limited to instances of gross managerial failure." *Id.* at 1200.

In defense of the neoclassical theory, however, the recent growth of junk bond financing has shown that large corporations are no longer invulnerable to a takeover bid. The

holder interests and providing an incentive for derivative litigation over the duty of care.³³ They believe that management influence over outside directors is so great that without liability rules the board would have little incentive to challenge management's recommendations.³⁴

This Note does not attempt to resolve the dispute over the effectiveness of liability rules and market mechanisms in regulating management behavior. Instead, this Part examines the second component of the Delaware approach—the use of private contracting through charter amendments to determine optimal levels of liability.

The use of charter amendments in the Delaware approach is based on the neoclassical economic theory of the firm. The neoclassical model views the firm as a nexus of contracts—contracts between the firm and investors, employees, suppliers, and consumers.³⁵ In large, publicly held corporations, the separation of

ultimate effectiveness of the market for corporate control will depend on whether the law continues to permit corporations to adopt antitakeover measures. See Gilson, *supra* note 29, at 844-45, for a discussion of the dangers of antitakeover measures. See also *infra* note 60.

33. The driving force behind duty of care derivative litigation is the plaintiff's attorney. Without any director liability, there will certainly be a dramatic reduction in both valid and frivolous duty of care claims. For a discussion of the role of plaintiff's attorneys in enforcing derivative claims, see Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669 (1986). Coffee noted that "our system has long accepted, if somewhat uneasily, the concept of the plaintiff's attorney as an entrepreneur who performs the socially useful function of deterring undesirable conduct." *Id.* at 678.

34. Critics of the neoclassical model argue that reputation and market factors are not powerful enough forces to overcome the pressure of collegiality in the boardroom. See, e.g., M. EISENBERG, *supra* note 1, at 145. The structural bias that grows out of a business ethic under which directors are expected to protect management from attack by outsiders makes outside directors reluctant to challenge management actions.

Some theorists have even posited the general lack of corporate accountability as a product of American cultural disfavor for any meddling with business affairs. A recent *New York Times* article discussed the cultural characteristics which accounted for American reluctance to overturn authority:

In addition, Americans are taught from an early age to value and respect individuality, to resent meddling with their business affairs, and to loathe any system that smacks of a Big Brother type of watchdog. In business, that often translates into a distaste for any system of checks and balances on executive behavior, even from a chief executive's board.

Prokesch, *America's Imperial Chief Executive*, N.Y. Times, Oct. 12, 1986, § 3, at 1, col. 1, at 25, col. 3.

35. For a more sophisticated explanation of the neoclassical theory of the firm, see Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). For a critique of the "nexus of contracts" theory, see Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Con-*

ownership and control represents an efficient contractual specialization of function. The rational investor will invest in several different enterprises in order to minimize his risk.³⁶ He lacks the management skill and the inclination to watch closely over the businesses in which he has invested, so he contracts with professional managers to supervise the corporation. Managers benefit because they can pursue profitable business opportunities even though they lack large personal wealth.³⁷

This theory also recognizes certain costs inherent in the investor-management contractual relationship. The most important of these costs, labeled "agency costs," is the incentive that managers and directors have to shirk their duties.³⁸ Because managers are not risking their own money, they have less incentive to concentrate on maximizing firm wealth than if they themselves were the principals.

Two mechanisms can reduce agency costs: market forces and private bargaining. Competition in the securities and employment markets reduces the divergence of interests between managers and investors.³⁹ Neoclassical theory also recognizes that shareholders can use their bargaining position in the contractual relationship to negotiate disincentives to management self-dealing. For example, stock bonus plans provide an incentive for wealth maximization by indexing management compensation to the overall wealth of the firm.

This concept of stockholder-management bargaining justifies the charter amendment approach conceptually. By requiring stockholder approval of a charter amendment, section 102(b)(7) allows stockholders and directors to allocate the optimal amount of duty of care liability. In a perfect market situation, with no contracting costs, this approach would be ideal. One might easily imagine that for many highly competitive industries, stockhold-

tract, 85 COLUM. L. REV. 1403 (1985); Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF THE BUSINESS 55 (J. Pratt & R. Zeckhauser ed. 1985).

36. Under the "portfolio theory," an efficient portfolio requires investments in a large number of firms in different industries. A diversified investor will thereby assume the risk of the market as a whole, called the systematic risk, but avoid the risk specific to each individual firm. For a discussion of how duty of care liability can reduce the level of systematic risk, see Cox, *Compensation, Deterrence, and the Market as Boundaries for Derivative Suit Procedures*, 52 GEO. WASH. L. REV. 745, 748-52 (1984).

37. Fischel, *supra* note 28, at 1262.

38. Agency costs include, in addition to the residual loss from the failure to maximize wealth, the costs of monitoring management behavior, and the costs of providing shareholders with assurances that management will not shirk their duties. See Jensen & Meckling, *supra* note 35, at 308.

39. See *supra* notes 28-31 and accompanying text.

ers may wish to allow directors to opt out of duty of care liability in order to encourage risk-taking and to reduce the heavy costs of insurance indemnification. Others may wish to put a cap on liability, while still others, who have less trust in management, may not wish to alter the status quo. Whatever the position of stockholders, the current insurance crisis demonstrates that unlimited liability is not optimal for many corporations, especially those that cannot afford insurance.

B. A Problem with the Delaware Model: Information Costs

Although the charter amendment approach may be conceptually attractive because it allows parties to allocate optimally their own risk, the realities of shareholder bargaining power suggest that charter amendments are rarely a product of fair bargaining. Widespread shareholder apathy,⁴⁰ combined with management control of the proxy process,⁴¹ suggests that these parties may not be able to allocate fairly the risk of director negligence. Unless institutional investors demonstrate a greater interest in corporate governance, any attempts to eliminate or limit liability through charter amendments will usually reflect a bias in favor of the management position.

Critics of the agency-costs theory have noted that in large publicly held corporations scattered investors have little or no ability to negotiate the terms of management's employment.⁴² Shareholders often are asked merely to ratify a charter amendment which interested directors have proposed. The shareholders are limited to rejecting or accepting the deal formulated by the interested directors. Even if the proposed amendment was reasonable, the stockholders should be entitled to have someone negotiate the optimal level of director liability with shareholder interests in mind. The interested directors cannot fulfill that role.⁴³

40. See *infra* notes 46-49 and accompanying text.

41. See *infra* note 43 and accompanying text.

42. For an extensive criticism of the agency-costs theory, see Brudney, *supra* note 35, at 1414-20. Professor Brudney disputes the contention that stockholders have the ability to contract with management, or that the market can effectively implement investor constraints on management. Stockholders do not have the knowledge or ability to learn about or affect the terms of the relationship that they are supposedly contracting.

43. This dilemma is analogous to the problem which occurs when shareholders are asked to ratify corporate transactions with interested directors. Shareholders are entitled to have the best deal possible negotiated for them, not to have their choices limited to

Not surprisingly, an initial informal survey of charter amendment proposals conducted in the first few months after adoption of section 102(b)(7) found that virtually all were for the complete elimination of liability.⁴⁴ Given the high costs of D & O insurance and management's self-interest in reducing their exposure to liability, management has little reason not to propose a complete elimination of liability unless it anticipates difficulty selling the idea to shareholders. In smaller companies and financially troubled companies, management may have trouble convincing shareholders to eliminate liability, but the vast majority of Delaware corporations are not likely to encounter substantial resistance to charter amendment proposals to eliminate liability.⁴⁵

One factor that decreases shareholder negotiating power stems from the structural advantage management retains in the proxy system. For an independent shareholder, the opportunity costs of reviewing a proxy statement and subsequently casting a vote outweigh the benefits of an informed vote.⁴⁶ This phenomenon is commonly referred to as the rational apathy problem.⁴⁷ Unless the individual shareholder possesses a large block of stock, his personal vote will have little or no impact.⁴⁸ Even if the costs of review are minimal, a rational shareholder may seek a free ride and abstain from voting if he believes that enough of the other shareholders will respond.⁴⁹ Because of individual shareholders'

rejecting or accepting a deal formulated by interested parties. See Marsh, *Are Directors Trustees? Conflict of Interest and Corporate Morality*, 22 BUS. LAW. 35, 48-49 (1966).

44. See *Early Foul-Ups in the Stampede to Delaware's New Liability-Limiting Statute*, CORP. CONTROL ALERT, Aug. 1986, at 7 (news update published by *The American Lawyer*). None of the lawyers consulted were aware of any company that has chosen to cap liability instead of eliminating it completely.

45. Charter amendments proposed by financially troubled corporations probably face a far greater chance of defeat for the simple reason that stockholders will be more alert to directors' attempts to avoid liability. Shareholders usually take a greater interest in board decisions when a corporation's viability is at stake.

Closely held corporations and smaller corporations will fit the negotiating model of the agency-cost theory better than large corporations because the rational apathy problem will decrease as the number of shareholders decreases. Shareholders in a closely held corporation are likely to be directly involved in management or the supervision of management, and the percentage of their ownership will be substantial.

46. For a general discussion of this problem and stockholder voting, see R. CLARK, *CORPORATE LAW* 390-92 (1986).

47. *Id.*

48. Institutional investors almost always own sufficient stock to warrant their informed voting on corporate governance questions. See *infra* notes 50-56 and accompanying text for a discussion of institutional investor voting.

49. Because an active shareholder cannot retain all the benefits of his supervisory efforts unless he owns 100% of the stock, an externality is created. Other shareholders will recognize this and try to reap the benefits of this externality without incurring the

preference for the free ride, shareholders' interests in large publicly held corporations will not be represented unless a shareholder amongst them has vast interests that outweigh the costs of informed voting. Large institutional investors can often fulfill this role.

C. *Institutional Investors: A Correcting Mechanism?*

This section considers whether institutional investors can supply the bargaining power which the charter amendment approach requires but individual shareholders lack. Institutional investors have the resources and motivation to cast informed votes on charter amendment proposals.⁵⁰ If institutional investors represented the interests of all stockholders, then charter amendments would reflect effective bargaining over risk allocation. The evidence, however, suggests that most institutional investors, with the possible exception of public pension funds, are reluctant to involve themselves in such corporate governance questions, and, when they do vote, they rarely oppose management.⁵¹ If this behavior continues, shareholder interests will not be adequately represented in most proceedings to adopt charter amendments that restrict or eliminate director liability.

Historically, institutional investors have been reluctant to involve themselves in corporate decisionmaking.⁵² If corporate policies appear inappropriate, institutional investors have preferred

costs of informed voting. See Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure*, 25 UCLA L. REV. 738, 778-80 (1978), for a thorough discussion of the free rider problem.

50. The term institutional investors includes banks, insurance companies, mutual funds, public and private pension funds, and nonprofit institutions such as university endowments. Institutional investors are the largest holders of stock in most of the nation's leading corporations. A 1978 Senate study on institutional investor holdings found that large institutional investors often hold "over five percent of the outstanding shares of a major corporate enterprise and many multiples of that held by the largest individual investors." J. ALLEN, *THE EXERCISE OF VOTING RIGHTS BY LARGE INSTITUTIONAL INVESTORS* (1977), reprinted in STAFF OF SUBCOMM. ON REPORTS, ACCOUNTING & MANAGEMENT OF THE SENATE COMM. ON GOVERNMENTAL AFFAIRS, 95TH CONG., 1ST SESS., *VOTING RIGHTS IN MAJOR CORPORATIONS* 559, 569 (Comm. Print 1978).

For a recent example of the vast holdings of public pension funds, see Dunphy, *Wall Street's Waking Giants*, Det. Free Press, Feb. 1, 1987, at 1G, col. 2. The article lists the State of Michigan Pension Fund's top 10 stock holdings, including the number of shares, percentage of the firm owned, and rank among shareholders. For example, the Michigan Pension Fund is the top shareholder of Chase Manhattan Corporation with 3.8 million shares, constituting a 4.7% ownership of Chase. The Pension Fund has \$14.2 billion in assets.

51. See *infra* note 63 and accompanying text.

52. M. EISENBERG, *supra* note 1, at 57:

to liquidate their holdings, if possible, rather than remaining and seeking a change in management policy or personnel.⁵³ The failure of institutional investors to exercise their power to influence management has often led to the entrenchment of management by default.⁵⁴ Even when institutional investors vote, they rarely oppose management. Professor Melvin Eisenberg has advanced several reasons for this pro-management position: personal feelings of obligation to follow the mores of the financial community; a desire to stay on good terms with management in order to obtain inside information; and, in the case of certain institutions such as banks, a desire to retain or cultivate business in a noninvestor capacity.⁵⁵

Institutional investors, particularly public pension funds, have started to challenge management more often. In 1985, the Council of Institutional Investors was established to give pension funds a greater voice in corporate governance matters and serve as a catalyst for more active institutional investment.⁵⁶ The long-run effectiveness of the Council remains to be seen, but anecdotal evidence suggests that some public pension funds are starting to crusade against management policies that threaten shareholder interests.⁵⁷

Despite the increased participation of pension funds, other institutional investors are not likely to alter significantly their past voting behavior. Investment companies and banks are particu-

Generally speaking, the institutional investors have taken the position that their primary obligation lies to their own beneficiaries, not to their fellow shareholders in portfolio companies; that they have neither the time nor the skills to exercise an oversight function; and that a company whose management should be changed is normally an unsound investment, so that an investor who does not like incumbent management should switch out of the investment as quickly as possible, rather than stay in and try to accomplish a change.

53. *Id.*

54. See D. BAUM & N. STILES, *THE SILENT PARTNERS* 160 (1965). Baum and Stiles argue that institutional investors have a duty to their fellow shareholders to oversee management. With the power of their holdings comes the responsibility of informed voting.

55. M. EISENBERG, *supra* note 1, at 57. Institutional investors can use their power to maintain close contacts with management. These contacts are useful for confirming rumors or simply keeping informed of company developments. The information they obtain rarely constitutes material nonpublic information under Rule 10b-5 of the Securities Exchange Act of 1934; nevertheless, it is of value to investors.

56. *Hearings Focus on Pension Plan Role in Voting Corporate Governance Proxies*, 17 Sec. Reg. & L. Rep. (BNA) 130, 131 (Jan. 18, 1985).

57. See Dunphy, *supra* note 50. Dunphy discusses the reaction of the Council of Institutional Investors to the General Motors decision to buy out H. Ross Perot. The Council insisted that General Motors Chairman Roger Smith attend a meeting in New York to defend the company's actions. Members of the Council control more than seven million shares of General Motors stock.

larly vulnerable to corporate pressures to approve antitakeover charter amendments or similar measures. They risk the loss of the business of that corporation in future transactions if they adopt a confrontational attitude.⁵⁸ Pension funds are able to avoid these pressures because they do not have to maintain separate business relations with management outside of their particular investment in the company.

The risk of legal liability that may result from any group efforts to monitor management also deters institutional investors from supervisory activism. If institutional investors combined their forces to elect directors, they could be found to be "controlling shareholders" and *prima facie* liable for any violations of securities laws committed by the companies they control.⁵⁹ They may also be considered insiders and forced to surrender any short swing profits as defined under section 16(b) of the Securities Exchange Act of 1934.⁶⁰ Finally, if a group of investors combined to elect directors in competing companies, they may be liable for violating the Clayton Act antitrust laws.⁶¹ Resolution of these problems is a prerequisite for institutional investors to participate in the supervision of their portfolio companies.⁶²

58. E. FLAX, VOTING BY INSTITUTIONAL INVESTORS ON CORPORATE GOVERNANCE QUESTIONS, 1985 PROXY SEASON (Investor Responsibility Research Center Corporate Governance Service, Oct. 1985) [hereinafter IRRC STUDY]. The study cited testimony from Labor Department hearings held in January 1985 on the role of pension funds in the corporate governance process. At those hearings, Roger Murray, a long-time director of mutual funds, noted:

The investment manager retains his clients and earns his fees by delivering good performance, which is measured against market indexes at frequent intervals. No plan sponsor adds to the performance measures points for thoughtful consideration of corporate governance issues. On the other hand, voting portfolio shares against the antitakeover proposals of a present or prospective client is seldom perceived as the best way to cement or create a warm relationship.

Id. at 19.

59. Professor Conard has written on the problem of potential liability of institutional investors for supervisory activism. Conard, *supra* note 21, at 281-83. The liability of controlling shareholders is enumerated in the Securities Act of 1933, § 15, 15 U.S.C. § 77o (1982); and in the Securities Exchange Act of 1934, § 20, 15 U.S.C. § 78t (1982 & Supp. III 1985).

60. Conard, *supra* note 21, at 282; see Securities Exchange Act of 1934, § 16(b), 15 U.S.C. § 78p(b) (1982).

61. Conard, *supra* note 21, at 282. The Clayton Act forbids the same person from holding directorships in competing companies. Institutional investors could be found liable if directors elected with their support were found to be *de facto* deputies of the institutional investors. See 15 U.S.C. § 19 (1982).

62. See Conard, *supra* note 21, at 293-94, for his suggestions for reform. He recommends amending the language of the relevant provisions of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Clayton Act to exclude their application to institutional investor supervision of management.

A recent Investor Responsibility Research Center (IRRC) study of institutional investor voting on antitakeover charter amendments indicates that the level of opposition to antitakeover proposals has increased, although it has amounted to a rejection of only four percent of all antitakeover proposals.⁶³ The remarkably high approval rate for antitakeover measures indicates the likely success rate of proposals to eliminate duty of care liability. Antitakeover proposals arguably endanger stockholder interests by entrenching management and thereby impeding the ability of the market to deter poor management with the threat of hostile takeovers.⁶⁴ In addition to losing this market mechanism for monitoring director performance, stockholders forego the potential opportunity to sell their shares at a premium in the event of a hostile bid. Proposals to eliminate duty of care liability may pose a similar threat to stockholder interests by reducing existing constraints on directors' shirking of their responsibilities and eliminating a source of compensation in the event of a successful duty of care derivative suit.⁶⁵

The high success rate of antitakeover proposals also reflects careful research by management before submitting any charter amendment proposals. The IRRC study indicates that many corporations are using proxy solicitation firms and public relations firms to survey shareholder voting behavior and evaluate the

63. IRRC STUDY, *supra* note 58, at 15. Of the more than 450 antitakeover charter amendment proposals which the IRRC obtained voting results for, only 19 proposals were defeated. *Id.* at 1. The study noted:

Even though most proposals won approval in 1985, the level of opposition was noteworthy in many instances. In fact, a comparison of voting results for 1985 and 1984 shows that the level of opposition was actually higher in 1985 for some types of proposals. These levels of opposition are a fairly sure sign of continuing institutional opposition to antitakeover proposals. While some institutions may have succumbed to pressures to soften their opposition to shark repellents, many others have maintained or even heightened their opposition.

Id. at 15.

64. The market for corporate control cannot effectively deter inefficient management if target corporations are able to enact antitakeover plans that raise the transaction costs of acquiring a corporation. See Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981); Gilson, *supra* note 29, at 844-45. Easterbrook and Fischel argue for a rule of managerial passivity under which management of the target company would not be allowed to resist a bid. But cf. Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231 (1980). Lipton argues that the threat of takeovers may impair management performance by overemphasizing short run stock prices at the expense of longer term investment.

65. This threat to shareholder interests must be balanced against the benefits to the corporation resulting from lower insurance payments, less litigation, and the freeing of the directors to engage in efficient transactions that they do not now enter into because of fear of lawsuits. See *supra* notes 14-19 and accompanying text.

chances of success before putting proposals on the ballot.⁶⁶ Some corporations have chosen not to introduce antitakeover charter amendment proposals when they perceived a substantial risk of defeat.⁶⁷ This suggests that the possibility of defeat may deter some corporations from proposing charter amendments to limit liability.

The results of the IRRC study suggest that the power of shareholders to negotiate director liability is grossly inadequate. Even with record levels of institutional investor opposition to management on corporate governance questions, shareholders defeated only four percent of all antitakeover charter amendments.⁶⁸ Unless institutional investor opposition increases, management proposals to eliminate the duty of care liability should pass without difficulty in financially sound corporations. The elimination of directors' liability may be appropriate for some companies; however, the constraints on shareholders inherent in the principal-agent relationship belie the claim that each company will reach the optimal level of liability through management-investor bargaining.

II. A PROPOSAL TO AMEND SECTION 102(b)(7)

This Part proposes a modification to the Delaware approach to mitigate the weak bargaining power of shareholders. The proposed statutory reform would require sunset provisions on charter amendments that limit directors' duty of care liability and mandate periodic renewal of such charter amendments by shareholder vote. This suggestion appeared originally in a tentative draft of section 7.17(c)(1) of the American Law Institute's Corporate Governance Project.⁶⁹ At the time of this writing, the ALI has not reached an official position on this issue.

A. *Sunset Provisions on Charter Amendments*

In order to compensate for shareholders' lack of bargaining power, an enabling statute such as section 102(b)(7) should include a sunset provision that would cause liability-limiting char-

66. IRRC STUDY, *supra* note 58, at 1.

67. *Id.*

68. *Id.*

69. Tentative Draft No. 6, *supra* note 27, § 7.17(c)(1); see reporter's comments, *id.* at 238-39.

ter amendments to expire after a period of time.⁷⁰ The legislature would fix the appropriate length of time, but a suggested measuring stick would be the normal duration of a board member's single term. In those corporations where directors do not serve staggered terms, shareholders could contract over the appropriate level of liability prior to each board election. If a director did not approve of those terms, he could choose not to run for reelection rather than resign in midterm. This scheme would fit neatly into the contracting theory,⁷¹ because shareholders would, in effect, be negotiating the appropriate level of liability while negotiating who will serve as a director. Even in corporations where directors are elected intermittently, this method would provide a yardstick of how often shareholders and directors have deemed it necessary to renegotiate their contractual relationship by reelecting or voting out directors.

Requiring periodic renewal by shareholders would, at a minimum, strengthen the conceptual basis of section 102(b)(7) by reducing the adhesive nature of charter amendments. Without a sunset provision, investors who purchase shares after the original passage of the charter amendment are forced to accept duty of care liability terms that may not be to their liking. The future shareholder could, of course, invest elsewhere, but, if duty of care limitations are adopted on a widespread basis, that may not be a viable option. A bargaining approach to duty of care liability, as adopted in section 102(b)(7), must therefore provide future shareholders with a method of altering duty of care liability agreements which they had no influence over. Mandatory sunset provisions would provide shareholders with an inexpensive and simple mechanism for reestablishing duty of care liability. If shareholders were forced to introduce their own proxy proposals to revoke previously ratified charter amendments, the enormous costs involved would deter all but the rare shareholder.⁷²

Those states that wish to follow the charter amendment approach but do not want to remove all potential sanctions on directors might couple the sunset provision proposal with non-

70. Apparently, sunset provisions have not been used before for charter amendments, so predicting what period of time would be appropriate is difficult. The ALI proposal suggests specifying the relevant period so that it "extend[s] to a date reasonably after the annual proxy vote, thus giving incumbent directors an opportunity to resign in the unlikely event that shareholders failed to renew the provision." *Id.* at 239.

71. See *supra* text accompanying notes 35-39.

72. For a discussion of the Securities Exchange Act of 1934 § 14a-8 requirements for shareholder proxy proposals, see Curzan & Pelesh, *Revitalizing Corporate Democracy: Control of Investment Managers' Voting on Social Responsibility Proxy Issues*, 93 HARV. L. REV. 670, 672-77 (1980).

monetary sanctions. For example, states could prohibit a director found liable for breaching their duty of care from serving as an officer, director, or consultant in any corporation for a period of time.⁷³ Although not as effective a deterrent as unlimited liability, these career sanctions could be an effective reminder to directors of the importance of the duty of care.

B. Problems with Sunset Provisions

Whether or not sunset provisions can actually alleviate the weak bargaining position of shareholders depends on certain assumptions regarding shareholder voting. This section discusses problems that may prevent sunset provisions from providing any meaningful protection of shareholder interests.

If shareholder apathy prevents effective voting on original charter amendment proposals,⁷⁴ why expect greater interest in future ratifications? Reducing the costs of shareholder voting enough to eliminate this problem is not feasible, but repeated voting may increase shareholder awareness. Disclosure in a public corporation's annual proxy statement⁷⁵ of the pros and cons of the charter amendment would educate many otherwise uninformed shareholders. A special requirement of repeated shareholder approval might also provide significant symbolic value because it would reinforce the importance of the fiduciary relationship between shareholders and directors.

This suggestion does not pretend that shareholders would eventually mobilize to engage in optimal arms-length bargaining with management.⁷⁶ Shareholders are unlikely to fail to renew

73. Professor Stone made this proposal in 1975. C. STONE, *WHERE THE LAW ENDS: THE SOCIAL CONTROL OF CORPORATE BEHAVIOR* 148-49 (1975). Stone would prohibit the director from serving as an officer, director, or consultant of any corporation doing business in interstate commerce for three years. He argues:

The advantages of the "suspension" provision, by contrast, are that it is not so easy to get around (notice the "or consultant" proviso); it is not so severe that, like potential multi-million-dollar personal liability, it would strike courts as unthinkable to impose; but at the same time it would still have some effective "bite" to it—the suspendees would be removed from the most prestigious and cushy positions ordinarily available to men of their rank, and would, I suspect, be objects of some shame among their peers.

Id. at 149.

74. See *supra* text accompanying notes 46-49.

75. The tentative ALI proposal recommends annual disclosure in a public corporation's proxy statement. Tentative Draft No. 6, *supra* note 27, at 238.

76. Indeed, portfolio theory assumes that shareholders are not interested in engaging in supervision of their individual portfolio investments. They diversify their holdings in order to minimize firm-specific risk. See *supra* note 36. Unlike individual shareholders,

the provision after its original approval if management is perceived to be doing a good job. Management also has the power to lobby for favorable votes if they fear a possible defeat.⁷⁷ They could engage in strategic behavior by tying in sunset provisions with other proposals that might act as "sweeteners."⁷⁸ If a corporation subsequently became financially troubled, however, shareholders would be much more suspicious of a management proposal to eliminate liability and they would probably be far more active in representing their interests, whether that meant reinstating full liability or not.

The unknown variable that will determine the ultimate effectiveness of charter amendments is the institutional investor. If institutional investors disapprove of duty of care limitations and find that they cannot avoid these terms by investing in other comparable firms, then they will likely increase their interest in corporate governance issues such as duty of care limitations.⁷⁹ This involvement would provide the type of shareholder bargaining power that the Delaware approach envisions.

Section 102(b)(7) modified as recommended above is not a perfect solution. It is an attempt to form a compromise between legitimate concerns over mismatched director liability and the need to protect the rights of shareholders from management erosion. The existing system of insurance indemnification fails to serve anyone's interests effectively. The deep pocket offered by insurance indemnification promotes frivolous litigation and leads to the eventual payment of judgments out of the corporation's own funds.⁸⁰ Any attempt to reduce duty of care liability

however, institutional investors are often constrained from selling all their shares at the first sign of bad management because their holdings are too large to be dumped without depressing the market.

77. Professor Seligman has criticized the proposed use of sunset provisions for dual class capitalization plans on the grounds that management influence over the proxy system would prevent any effective opposition to ratification. Seligman, *Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy*, 54 GEO. WASH. L. REV. 687, 723-24 (1986).

78. *Id.*

79. See *supra* notes 56-57 and accompanying text, discussing the increased vocal opposition of pension funds to management actions of which they disapprove.

80. Professor Conard has accurately described the indemnification mess:

In order to counter their directors' imminent risk of incurring large defense costs and their remote risk of eventual liability, corporations have developed the twin practices of indemnifying directors by payments from corporate treasuries and buying directors' insurance by payments that come directly from corporate treasuries or indirectly by way of increased directors' fees.

Although insurance is rarely sufficient to cover directors' potential liability, it is usually adequate to pay for a settlement of claims, including fees for plaintiffs' counsel. Plaintiffs and their lawyers are usually glad to settle because they would

is bound to erode incentives for the enforcement of shareholders' derivative rights.⁸¹ One must balance this loss, however, against the gain to shareholders resulting from more effective management decisionmaking, the recruitment of qualified outside directors, and the ultimate decrease in litigation and insurance costs. At least if directors prove to be less diligent in their decision-making, this proposal will provide shareholders with a mechanism for reinstating unlimited liability or imposing a limited cap on liability.

CONCLUSION

Delaware's adoption of section 102(b)(7) represents a redefinition of the investor-management relationship. The new statute rejects the traditional use of mandatory liability rules for the enforcement of a director's fiduciary duty of care and, instead, relies on private bargaining and market constraints. Shareholders and directors may now use charter amendments to allocate the risk of director negligence as they see fit.

The problem with this new approach is that shareholders are in a weak position to bargain over duty of care liability. Although the elimination of liability may be optimal in some circumstances, it is conceptually inaccurate to claim that shareholder consent will result in an optimal arrangement.

Other states will no doubt consider enabling legislation similar to Delaware's section 102(b)(7). States which choose to follow this charter amendment approach should include in their enabling statute an automatic sunset provision which would require periodic shareholder approval of any limitation on directors' liability. This provision would serve as a more sound conceptual foundation for the bargaining approach to investor-director relations. It may also help alleviate the weak bargaining position of shareholders by increasing their awareness of these charter

have to invest more and more money in the suit as it dragged on and they might lose it altogether if they pursued it to final judgment. Similar considerations incline the directors toward settlement. Although the law imposes restrictions on indemnification and insurance coverage when directors are found guilty or found liable, a settlement before judgment preempts any such finding. The concatenation of liability, indemnification, insurance, settlements, and awards of attorneys' fees accomplishes very little that is beneficial, and a great deal that is detrimental.

Conard, *supra* note 21, at 267-68 (footnotes omitted).

81. See *supra* note 33 (discussing the importance of the plaintiff's attorney in initiating derivative suits).

amendment provisions and providing them with an opportunity to reinstate liability if they are unhappy with management performance.

—*Craig W. Hammond*

